DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92038

36 Letters per Year

Registered with the Securities Exchange Commission

October 6, 1976 Letter 677

Sept. 24, DJIA 1009.31; PTI 718; A-D Ratio -21.41
Oct. 1, DJIA 979.89; PTI 709; A-D Ratio -22.29

PSYCHOLOGICAL WARFARE: In Letter 674 I first drew attention to the collapsing British market. In Letter 675 I included a chart showing the correlation between the US and British markets. To put it briefly, a sliding London stock market is usually negative for Wall Street.

There's no doubt in my mind that the eerie slide of the pound sterling to all-time lows has upset the US markets. After all, the pound is still a widely-held currency. When a currency as "big" as the pound falls apart, there are going to be a lot of losses. And they are going to be big losses (the extent of which we'll probably learn weeks and months from now).

The US market has been engaging in "psychological warfare" with investors ever since last February. Each time the Dow gets above 1000, it staggers, stockholders panic, and down she goes. Each time the Dow sinks back to the 950 area, the fear seems to dissipate, and buyers come in again.

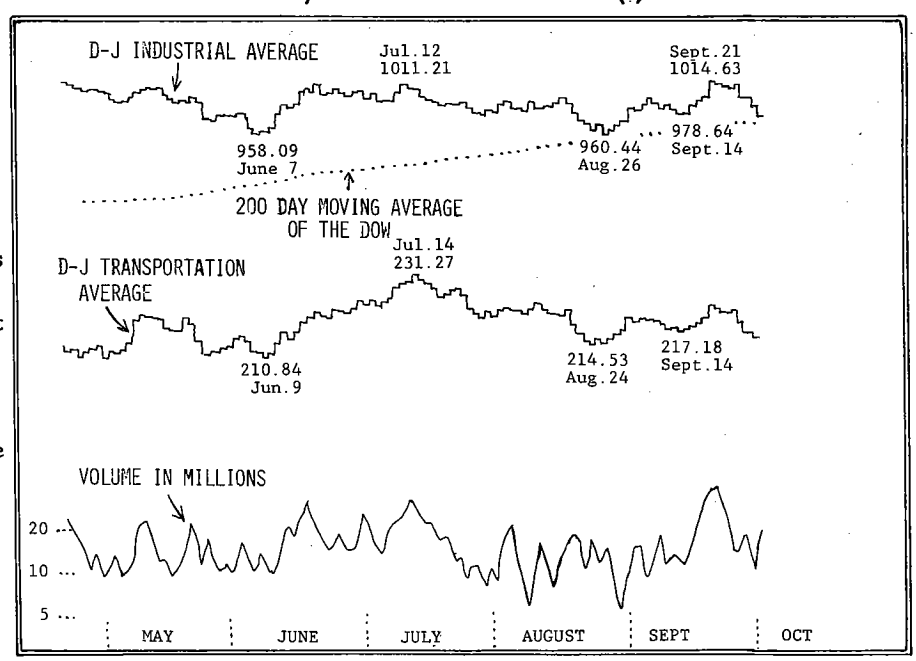
There's no doubt about it. The Dow 1000 to 1050 area represents the greatest resistance zone in the history of the stock market. If the Dow is to go through this area with conviction, it appears to me that we're going to have to have one of the most "sold out" markets in history. Since February, 1976, I count eleven separate stabs into the 1000 area by the Dow. Each one has failed to hold. But fear and discouragement (ironically) are a plus in a bull market. When enough people are convinced that "we'll never see a major swing above the Dow 1000 level," the ground for such a swing will be prepared. My guess is that each separate upside failure is taking us closer to that fabled bottom, the launching pad for the ultimate Dow advance over and out of the 1000 area.

I have written repeatedly that a primary bull market usually provides at least one (and often two) outstanding buying opportunities ("buy spots") per year. We have not had a really good buy spot since late-1975. It appears to me that a true buy spot is coming up. And as is so often the case, it's probably going to arrive during the month of October.

Buying spots in a bull market are generally of two varieties. The first is the simple non-confirmation, an area wherein one Average breaks a preceding low while the other refuses to confirm. We have seen this kind of action many times in this bull market.

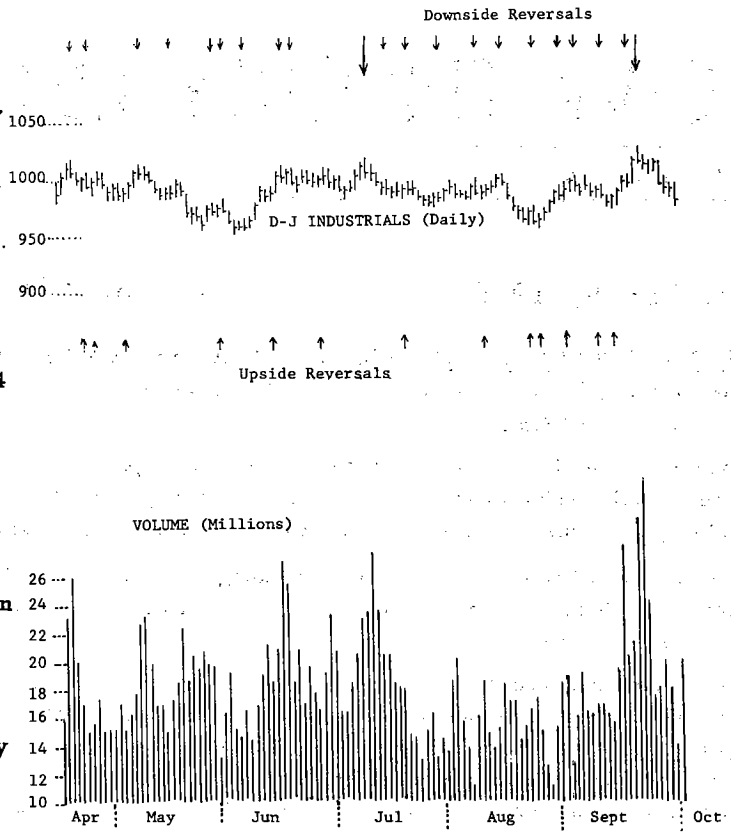
The other type of buy spot is something that we have not seen for many years. It is the old fashioned bull market "selling climax." The selling climax is characterized by a plunging panicky market, very high volume at the bottom, a breakdown in many blue-chip stocks, a churning of shares at or near the bottom (the churning is indicative of downside exhaustion), and the inevitable scare newspaper headlines. It is possible that we are heading for our first bull market selling climax bottom now. In the final analysis, perhaps no other market action can lay the base for the next real bull market advance.

I might as well mention that a characteristic of the selling climax bottom is that it tends to break all the so-called "support levels." Thus, it could be that 950 on the Dow will have to be broken in order to bring this market to a really sold-out condition. I don't know whether we are fated to see a selling climax or not and neither does anyone else on this earth. But (1) I do think that an outstanding buy spot is nearing, (2) I believe the second phase of this bull market is continuing and being extended, (3) I think that what is now occurring is healthy for the life of this bull market, (4) I think that it is time to lean against the prevailing market sentiment. And that sentiment is changing from discouragement to fear.



PRICE MOVEMENT: Where are we now as far as the Averages are concerned? Turn to the chart at the right and we'll try to make some sense out of the current action. We have two sets of significant points to watch. First, we have the recent September 14 lows of 978.64 for Industrials, 217.18 for Transports. Below those levels we have the more important August 26 lows of 960.44 for Industrials, 214.53 for Transports. Remember, and this is very important, it takes penetrations by both Averages through preceding points to provide valid conclusions. A penetration by one Average without the other is usually

meaningless for prediction purposes— and often deceptive. In fact, I prefer bottoms which are characterized by a penetration of a single Average without the other, the so called "downside non-confirmation.



Ever since August (see page 1 chart), the Industrial Average has been stronger than the Transport Average. This relative strength relationship will probably continue for a while. In other words, if any downside non-confirmation is to occur, it will almost surely be the Industrials that will hold.

On October 1 the Transports broke under their September 14 low, closing only a point above the August 26 low of 214.53. But Industrials held at 979.89, a few points above their September 14 low of 978.64 and 19 points above their August low of 960.44. Here is what we should now watch for: if Industrials can manage to hold above either the September low of 978.64 or the August low of 960.44, then we will have a downside non-confirmation and all may yet turn out all right. But if Industrials plunge through both the September and August lows, then I would say that the odds on a selling climax are high. That's a phenomenon we could all live without, but if it is fated to occur, it's better to be psychologically prepared.

ONE-DAY REVERSALS: I've had a habit, over the years, of marking on my chart the phenomenon which I term the "one-day reversal" (ODR). The ODR occurs any time the intra-day high for the Dow is above the previous day's intra-day high but the closing is below the previous day's low. The same is true on the downside, except that here I look for a lower intra-day figure with the closing above the previous day's close.

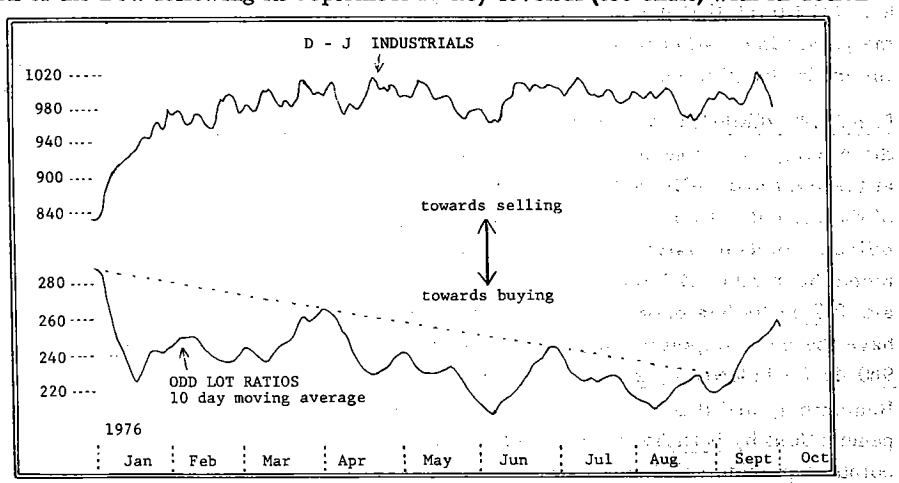
Occasionally, we have an ODR on very large volume (larger than anything in the preceding few weeks). I term this a "key reversal." Such days usually occur during (1) days of heavy distribution at the top or heavy accumulation at the bottom, or (2) days which represent extremes in sentiment such as fear at the top or a sudden desire to take on stocks at a low point.

The accompanying chart above shows all the Dow action with volume (daily) from mid-April, 1976 to the present. I have marked all the ODRs with a small arrow and the more important key reversals with a large arrow. The top reversals are identified by arrows pointing down and the bottom reversals have arrows pointing up.

The fierce struggle that has marked the Dow action in the 950 to 1025 area can be seen when we realize that there have been 19 ODRs to the downside since mid-April and 13 ODRs to the upside during that same period. During the same period we had two heavy volume key reversals, both to the downside. The first appeared on July 13 when the Dow turned down from the 1010 area on 27 million shares. This key reversal was followed by a general market decline which took the Dow to an August 26 low of 960.44.

From the August low the Dow worked itself up again, and by late-September the Dow was within shooting distance of the 1000 level again. On September 21 the Dow shot up over 20 points to close at a new bull market high of 1014.63. The next day, on volume of 33 million shares (see chart) the Dow rose to an intra-day 1025, then turned down to close at the 1010 level, 4 points below the previous day's close. This qualified as the second key reversal in the last five months--and it was again to the downside.

It will now be most important to compare the action of the Dow following its September 22 key reversal (see chart) with its action following the key reversal of July 13. Remember, the July 13 key reversal sent the Dow back to 960.44 by late August. The September 22 key reversal (occurring on a whopping 33 million shares) could conceivably do the same thing or worse. But so far, the odd-lot figures are more constructive, and the money market data continues strong. Therefore, I am hoping that 960.44 will hold.



Of course, another major difference between the key reversals of July 13 and September 22 is that the latest one occurred after a new high had been recorded in the Advance-Decline ratio. That could constitute an important plus in the current situation.

ODD LOTS: Here's another study I want to talk about at this time. The public's reaction (as exemplified by odd lots action) can frequently provide important hints as to the coming direction of the market. The chart (page 2) shows the daily Dow closes together with the buy-sell ratios for the odd-lot transactions (smoothed on a 10-day moving average). A figure of 260 means 260 odd-lot shares sold for every 100 bought, a figure of 220 means 220 shares sold for every 100 bought, etc. Since odd-lot action during 1976 has been heavily on the sell side, the figures are all in the 200 area. But it is the direction of the index that we watch rather than simply the level. The changes in direction (always in reference to the Dow action) can tell us much about the undertone of the market.

Note that the odd-lotters were selling heavily as the year opened, but as the Dow climbed into February the odd lots pulled back their selling (skepticism). The Dow then went flat. The odd lots then increased their selling into early April, as the Dow pushed over 1000. The move over 1000 evidently encouraged the public, and they decreased their selling from April to July.

In late-June the Dow popped over 1000 again, and the public first turned skeptical, then became encouraged. During July the odd lots decreased their selling and the Dow tumbled back to the August 960 area.

The most recent action (starting from mid-August) is most interesting, and it could be very significant. On September 21 the Dow pushed up to its high of 1014.63. But note that the odd lotters in early September increased their selling. This increase served to reverse the 8-month descending trendline of declining peaks. By the end of September odd lot selling was at a six month high.

Then came the market sell-off (starting September 22) and the odd lot ratio continued to climb into the sell zone. I will be most interested to see whether the current extremely high level of odd-lot selling continues with the Dow under 1000. Remember, each previous time when the Dow sank under 1000 the odd lotters pulled back on their selling ("lower prices are bargains"). If this sell-off keeps the odd lotters scared and selling heavily, we will have a change in reaction and sentiment. That could be bullish for the market.

I want to repeat again that the Dow has been banging into a fantastic area of resistance in the 1000 zone. If the Dow is to go through and above 1000, it will probably do so amid tremendous public skepticism. That skepticism will be reflected in odd lot selling which will be holding at very high levels. So far in 1976, we have not had a period in which the odd lot public stayed frightened. That period lies somewhere ahead.

APPRAISAL: I can't swear to it, I'm not ready to stake my life on it, but I think, I really think I'm "getting it together" regarding what this primary bull market is telling us. First, let's list a number of factors, all of which are actually happening today. Then let's see what they add up to.

(1) We have a primary bull market in stocks. The primary bull market is now in its second (psychological) phase. The bull is barely two years old.
(2) We have a primary bull market in bonds for the first time in thirty years. The D-J 20-Bond Average is currently at a 10-year high (see last Letter).
(3) We have a strong dollar (see Letter 665, page 5). It's been strong since late-1975.
(4) Commodities could be topping out or possibly moving into an era of stability (see later section of this Letter).
(5) Gold and Silver are well off their recent bottoms, but they appear to be languishing.
(6) Interest rates in the US have come down. They are at relatively low levels and stable.
(7) Liquidity has been building up at the corporate and consumer level. Liquidity has also been building up at the financial institutions (banks, S & L's, etc.).
(8) The US consumer is now rather conservative; he has been holding back on his buying, corporations have also been acting conservatively. No big capital goods boom is in sight.
(9) Corporate purchasers have been cautious. Inventories are building rather slowly.
(10) So far in this bull market, corporate profits have expanded dramatically. According to S. Jay Levy, the brilliant economic forecaster (S. Jay Levy, Box 26, Chappaqua, NY 10514), the rate of profit expansion will come down but nevertheless "reported profits next year will be at least 15% higher than 1976."
(11) While employment is high, unemployment is also holding at high levels.
(12) Consumer price increases have eased as have wage settlements. Price increases for consumer goods rose at a 5% rate during the first eight months of 1976.
(13) The public has been bearish regarding the stock market. They have been exiting ever since 1970. The rate at which the public has been cashing in its stocks has been (and is) extraordinary, perhaps $100 million a week.

I list all these factors, and I study them. And to be honest, I blink, I do a double take. What it all seems to add up to is that we are going into an extended period of stability, and that is exactly what the primary bull markets in stocks and bonds are reflecting and discounting. And it could be a very long-lived period because it's also grounded in conservatism and even skepticism.

But the conservatism and skepticism are bullish. They are the remains of the disillusionment of the 1970's, of Watergate and Viet Nam and double-digit inflation and violence in the streets. But the pendulum, as readers know, swings both ways, and my guess is that very slowly, almost imperceptably, the pendulum of public sentiment in this nation is going to swing back to neutral, then to hope, then optimism and finally to over-optimism.

As I see it, the hardest thing that the average investor will have to do in the period ahead is stay with this bull market. I feel that it's going to be a bull market in which the man who buys values and stays with them is going to come out way ahead. I think one should be in good stocks, income producers with dividends. I think one should be in good bonds or bond funds. I think we are going to have to hold our constructive attitude right through the skepticism. And I feel that this bull market is basically going to benefit the patient investors and holders, rather than the traders and the "players."

I have noted that almost all the investment services have been concentrating on their "short-term indicators." They have been rivited on the near-term trend. This fear-psychology has obviously emerged from the tragic and costly period of 1966-74. That bear market period made hash of the long-term investor and holder, the man who wouldn't let "them" shake him out of his holdings.

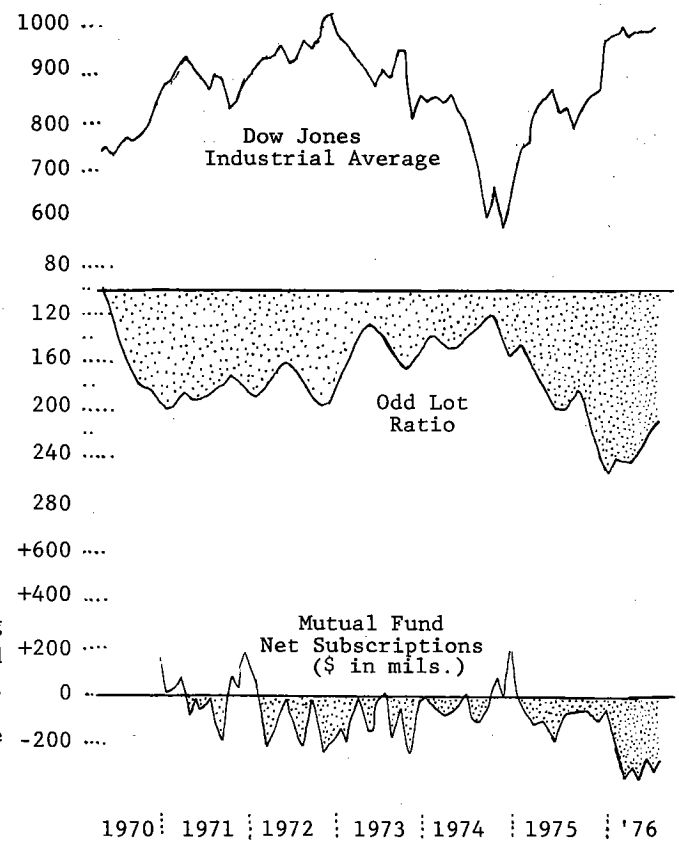
So what do we have now? A generally fearful and cynical public, a worried corporate leadership, a new conservatism. And they all add up to (1) an extended second phase of this bull market, and (2) a primary bull market which could last much longer (and perhaps go higher) than most investors and professionals are now expecting.

Question: Russell, in a few recent Letters you wrote that you thought the second phase of this bull market might be breaking up. Have you changed your mind?

Answer: I'm in the process of changing my mind. Some analysts are expecting a big speculative advance ahead, others are talking about a big bear market in 1977. The one thing nobody is thinking about is a continuing long, frustrating second phase filled with scares, frustrations, relapses, stops and starts. Yet that was how the second phase of the 1949-66 bull market developed, and I believe that there are more problems for the market to digest now than there were then.

I have said repeatedly that the second phase of a bull market is the longest, the most difficult and the most deceptive. Is there anyone who can deny that this second phase isn't shaping up just that way!

SECOND PHASE: When this bull market first began back in late-1974 I discussed the three phases (of a bull market) in detail. It is critically important for the investor to realize which phase he is in and what to expect in each phase. Therefore, for the benefit of new subscribers and with the indulgence of veteran subscribers, I am going to go over the bull market phases again.



First, it should be understood that phases refer to emotional or psychological periods. They do not have to do with the price movement. Actually, a bull market phase may contain one, two or more major market advances with as many corrections. However, each of the three phases of a bull market is usually separated by a correction. This has been true in the vast majority of bull markets, but even here the rule is not a fast one. For instance during the 1932-37 bull market the second and third phases were contained within one massive price advance. There was no separating price correction.

The first phase of a bull market represents the rebound from the depressed levels of the preceding bear market bottom. The first phase usually returns stock prices to something approximating "known values." The first phase of this bull market began around October-December, 1974. The first phase ended during July 1975.

Following the July peak, the market corrected to lows which were seen during the final quarter of 1975. From there the second phase of the bull market began. The second phase is usually the longest phase, and it is also the most deceptive. Here we may see false moves, violent non-confirmations and out-of-gear movements. The basic rationale for the second phase is that it represents the market's discounting of improving business conditions. The economy during the second phase may be exptected to advance but not boom. And stocks, in general, can be expected to do the same.

One of the characteristics of a bull market's second phase is that the public remains fairly skeptical (they were totally disbelieving during the first phase). But towards the end of the second phase the public may curb its fear and even start to do a little "nibbling." The public never gets enthusiastic during the second phase, however, because the news is never good enough (and even if it is good it is never obvious enough). Remember, the public only fully reacts to news, and the news turns bullish in the last psychological phase of a bull market.

It is normal for the second phase and the third phase of a bull market to be separated by a sharp and deep reaction, a reaction which usually turns the public (and Wall Street as well) black with fear. This is what happened during 1957, and I rather expect

it will happen when this second phase finally ends.

The third phase of a bull market is both the speculative and the distributive phase (in contrast to the first two phases which are accumulation phases). It takes good news to distribute stocks in quantity, and during the third phase the good news really emerges. Other characteristics of a bull market's third phase are high volume, standing room only in the board rooms, flying rumors, hot tips, and wild moves by the low-priced stocks, the "cats-and-dogs" and the specialty stocks. During the third phase dividend yields for stocks will average 3% or less and P/E ratios may get into the rarefied mid-to-high 20's area.

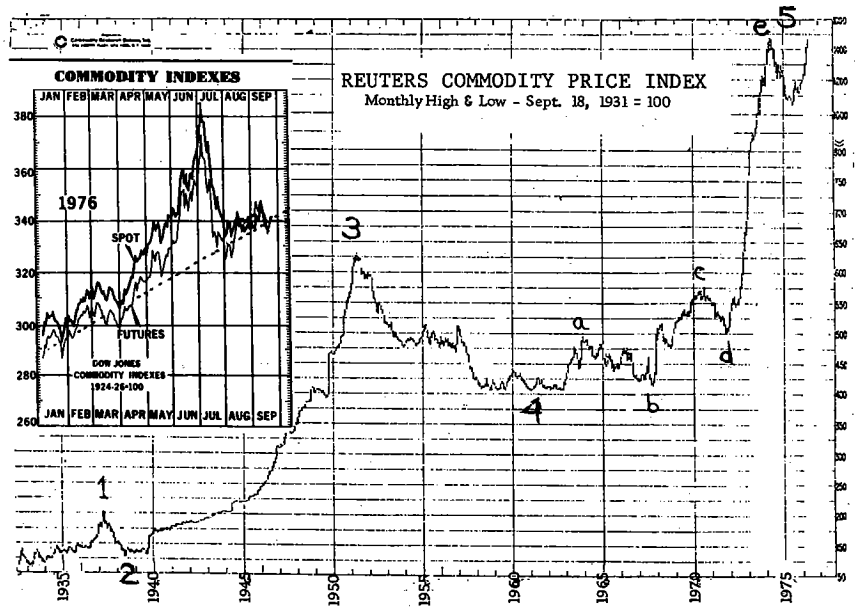
In view of all the foregoing I thought the page 4 chart would be particularly revealing. Here we see the Dow (plotted monthly) along with two very significant barometers of public sentiment. The first is the odd-lot ratio, and this chart plots the ratios in the form of a three-month moving average of the monthly buy-to-sell ratios. Note that the odd-lotters have been on the sell side of the market ever since 1970. Selling increased to 200 (200 shares sold for every 100 bought) during 1971, then declined steadily to 120 at the 1974 lows. Thus, the odd-lotter was tending to do the right thing, which was sell less as prices declined (actually, really correct action would have been to buy heavily at the 1974 bottom, rather than just to sell less).

But it is at the turns that the odd-lotter is famous for doing the wrong thing. And sure enough, as the bull market climbed during 1974 and 1975 the odd-lotter stepped up his selling to massive proportions. By February, 1976, the ratio of selling to buying hit an all-time high of 246 (246 shares sold for every 100 bought). Since February, the selling ratios have receded to around 224 (still a very high level).

A second barometer of public sentiment is the net buying or selling of mutual funds. The chart shows that mutual funds went into a net redemption area (more redemptions than purchases) for the first time in history during early 1971. Since then, with only two short respites, the public has been a net redeemer of mutual funds. The peak of selling (bearishness) occurred during the March to May period of 1976. Since then, net redemptions have receded slightly to August's figure of $280 million more redemptions than purchases.

So that gives us some idea of where the public stands at this time. As far as I am concerned, this chart is saying that we are still very much in the second phase of the bull market. The public, while not quite as bearish as they were at the beginning of 1976, is still very, very bearish. And this is as it should be. I don't expect to see a real switch in public sentiment during the entire second phase. But strange as it sounds, when the third phase of the bull market (probably following a severe correction) finally gets underway, I believe we are going to see both of these graphs swing into the plus column. Then, instead of the public dumping odd lots and funds at the rate of $100 million and more a week (!), we will see them buying perhaps the same amount. It could and I think it will happen.

COMMODITIES: The whole inflation-deflation thesis is quite fascinating at this time. For instance, commodities are a time-honored gauge of inflation. With that fact in mind, it is worth noting that the trend of commodities has been up, with only two major interruptions, since 1932. If you study the accompanying chart (courtesy Commodity Res. Bureau, One Liberty Plaza, NYC 10006), you will note that the two respites from commodity inflation occurred as follows: the period of 1938-40 as World War II was about to start, and 1950 to 1960, a period of stability following the Korean War. Two further periods, 1964-67 and 1970-72 occurred within the great upward swing of 1960 to 1974.



It may be of interest to subscribers to see how I divided the entire period of 1932 to the present. I have marked the period on the chart in Elliott terms, and if my classification is correct, we have witnessed (since 1932) a massive Elliott bull market in the form of five waves (three rising waves and two corrective waves down). Wave 5, which is usually the speculative wave, subdivides into five shorter legs (a through c on the chart). Note that final sub-wave e leading to final major wave 5 was so powerful that it took the Reuters Commodity Index from 500 to almost 1500, thereby tripling the price of this broad Index!

It is also of interest that the most recent rise in the Index could have produced a "double top" at the 1500 area. If so, we should be heading down during the period ahead. Moreover, if my Elliott interpretation is valid, we may have seen the peak for most commodity prices for many years to come.

The smaller chart insert shows the D-J Commodity Indices on a daily basis. I have drawn a trendline through the January, March and August bottoms, and we note that this nine-month trendline has now been penetrated to the downside. So I personally will be watching commodities carefully over the months ahead. The idea of a top-out in commodity price-inflation is one that would come as a shock to most people at this time.

The question might be asked, "What would the significance of a commodity top be within the context of the current primary bull market in stocks?" My answer is that the most bullish long-term force on the stock market is stability, not deflation and not inflation. Study the generally stable commodity price (see chart) from the period of 1958 to 1966. This happened to coincide with the third phase of the 1949-66 bull market, a time when the Dow rose from 419 to 1000. My own feeling is that a period of stability in commodities could be a bullish long-term force on Wall Street now. Certainly, the last thing we need is another blow-off in commodities.

How does the possibility of a long-term decline in commodity price jibe with the current widely accepted idea of "more inflation in the years ahead?" In a phrase, it does not jibe at all. Therefore, I am suggesting again that my subscribers keep an open mind regarding the forthcoming year or so. Remember, when everybody's thinking the same, nobody is thinking at all.

LATE NOTES & THOUGHTS: I just received the latest (October) Bank Credit Analyst (1245 Sherbrooke St. West, Montreal 109 Canada). Editor Tony Boeckh concludes in this issue, "Stock prices are a function of four things—the expected growth rate of profits and dividends, balance sheet liquidity throughout the economy, interest rates and risk. On all scores, the slowing of the recovery and the prospect of a continued below normal business expansion is highly positive for stock prices."

* * *

I have not heard the second Ford-Carter debate yet, but I feel that the debates are going to prove to be a minus for Carter. I personally think that Carter comes across as positively "devious" on TV. He spouts figures and statistics a mile a minute, but somehow I don't know where the man's "center" is. He's all brains fortified with immense ambition and drive, but where is he, what does he want? James Reston (New York Times), probably one of the ten most influential newsmen in the nation, writes (Sept. 22) that "It is clear from Mr. Carter's recent train journey that he has already lost considerable support among the press. Many of the reporters traveling with him are getting to know him better and enjoying him less. . . . They are increasingly skeptical of his sweeping generalizations about Democratic achievements and Republican failures in the handling of the economy. . . ."

Of course, it's a paradox, but historically the Democrats have had a bullish effect on the stock market (when the market is in a primary bull trend). Nevertheless, I feel a Ford victory would be long-term bullish and healthy for the US, and I base this on Ford's advisors and their generally conservative bent.

* * *

I am still comparing the current period with that of late 1956 and 1957. One difference is that the reaction in 1957 came "out of the blue," nobody could believe it was happening. But the 20% drop in the Dow in 1957 was discounting the severe recession of 1958. Today, almost everyone is cautious. Talk of possible slowdown and even recession in 1977 is widespread. Therefore, if the economy does stabilize or even turn down during 1977, I don't think it's going to develop into a severe economic contraction. What everyone is prepared for seldom occurs.

The market itself, I feel, has actually turned extremely conservative. The low P/E ratios of today are allowing for a good deal of hardship and problems in the period ahead. For instance, most of the bank stocks are selling well below book value, based on the mass of questionable to bad loans which they have put out. In many cases, the big banks are selling at a level which allows for a write-off of a huge chunk of potential bad debts and more.

The difficulty of today's market and the general skepticism and fear is having the effect of placing increasing institutional and general investment interest on present yields, rather than the possibility of appreciation and capital gains. This conservative line of thinking is directing a great deal of new money (and switch money) into bonds, utilities, and stable conservative stocks. In looking over current areas of group relative strength, I note the following groups are looking strong: Dairy Foods, Installment Finance, Offshore Drilling, Domestic Oils, Int. Oils, Publishing, Retail Food Stores, Retail Variety Stores, Savings & Loans, Tobacco. Almost all are conservative, "value" type groups, no flashy numbers here.

BONDS: The 7 3/4 Treasury Notes of 1981, which I have recommended and which I watch carefully, hit a new high of 103.4 last week. This is up five points from where they were first recommended. Add their original yield of 8% and you have a profit-appreciation of about 13%, not a bad performance for the world's safest investment. The action of the 7 3/4 notes is about typical of the rest of the bond market, which looks as if its going higher to me. I continue to like the entire money-market spectrum for return and appreciation.

Incidentally, one of the great problems with bonds is liquidity or buying (and particularly selling) when you want to or have to. Governments are extremely liquid as are most big name bonds (such as the Amer. Tel series or G M). But Municipal bonds can be a problem, and the new Municipal bond funds have now come to the aid of investors. Fidelity Mutual Bond Fund is the first no-load Muni fund. You can buy it with an initial investment of $5000, and thereafter put in smaller amounts. The Fund pays about 6%, Federal tax free. For information, you can write Fidelity at 82 Devonshire St., Boston, Mass 02109, or call toll free (800) 225-6190. I offer this information for the use of subscribers, and get not a penny out of it. But I do have some of my own money with the Fidelity Muni Fund.

GOLD, SILVER: If you need any further proof of the fact that gold and silver are not ready to climb into the blue yonder, look at their performance last week as the pound sterling collapsed. Had gold been in a bull market, last week's fiasco in Britain would have sent bullion through the roof. Note that gold is again below the halfway level (116.50) of its entire 1970-74 rise. As I thought it would, the 116.50 level proved to be an area of formidable resistance. Meanwhile, the gold shares and the group is still negative on a relative strength basis. I won't be positive on gold shares until the relative strength picture is positive. So far, and I've been in this business a long time, I'm just not smarter than the market.

Next Mailing: October 15th.